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IN THE

Supreme Court of the United States

October Term, 1947

No. 146

ARTHUR D. SCHULTE, JOHN S. SCHULTE and DAVID A. SCHULTE, JR., as Trustees under a trust agreement dated June 3, 1932, made by David A. Schulte, as Grantor, *Petitioners,*

against

PARK & TILFORD, INC.,

Respondent,

UNITED STATES OF AMERICA,

Intervenor-Respondent,

MARJORIE D. KOGAN, on her own behalf and on behalf of all other stockholders of Park & Tilford, Inc. similarly situated, and in the right of Park & Tilford, Inc.,

Intervenor-Respondent.

BRIEF FOR RESPONDENT, PARK & TILFORD, INC., IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

HIRSON, BERTINI & ROTHENBERG,
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MAX L. ROTHENBERG,
MAX M. HIRSON,
Of Counsel.

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Statement.

The respondent, Park & Tilford, Inc. (plaintiff below) brought this action against the petitioners pursuant to § 16(b) of the Securities Exchange Act of 1934,[1] which

[1] The text of the statute appears in Appendix A of the petition and will not be repeated here.

renders principal stockholders, directors and officers liable to their corporation for any profit realized from the purchase and sale of the corporation's listed securities within any six months' period.

A principal stockholder is defined (§ 16(a) of the Act)[1] as the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange. At the times here involved the petitioners were the beneficial owners of more than 10 per centum of Park & Tilford's registered common stock and therefore subject to the liability imposed by § 16(b) (R. pp. 6, 53).

ARGUMENT.

POINT I.

The reasons relied on in the petition for granting the writ do not satisfy the requirements of General Rule XXXVIII(5) of this Court. No important questions of federal law have been decided requiring consideration by this Court.

§ 16(b) was enacted to curb the widely condemned evil of short-swing speculations by corporate insiders with advance information.[2] It was found that such activities affected the securities market to the detriment of the more numerous "outside" stockholders. Therefore, to redress the balance, the statute makes it unprofitable for insiders to capitalize on their advantageous position.

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[2] *Smolowe* v. *Delendo Corporation*, 2 Cir., 136 F. (2d) 231, 235; cert. den. 320 U. S. 751.

To prevent evasion of the Act, § 16(b) expressly provides that any profit realized within the proscribed period shall inure to the company irrespective of any intention on the part of the insider, when entering into the transaction, of holding the security purchased for a period exceeding six months. And for the same end, the scope of the word "purchase" was broadened by definition [3] so as to render ineffectual the use of manipulative devices to circumvent the statute. Consequently, "Bona fide transactions, too, may be caught in the net of the law. But what is legitimately struck at is the tendency to evil in other cases".[4]

Petitioners concede (p. 10) that § 3(a)(13) was adopted to prevent the use of the option device as an instrument of evasion. They argue however that a convertible security does not resemble an option, and as it serves a useful economic purpose to the prudent investor it should be immune from the application of the statute. The weakness in the argument is that petitioners are unable to show that a conversion privilege is essentially dissimilar from an option and that it is not capable of being used as a device to evade the Act.

The conversion privilege attached to preferred stock is an option.[5] Like any other stock option it confers upon the holder the right to call upon the company for a specified number of shares. Whether the exercise of the right must be accompanied by a cash payment, the surrender of preferred stock, or both, is of scant importance to the nature of the device sought to be reached by § 3(a)(13). It surely is not to be ascertained by reference to its market label.

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[3] § 3(a)(13) of the Act provides: "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

[4] *Smolowe* v. *Delendo Corporation, supra,* at p. 240.

[5] *Cheatham* v. *Wheeling and L. E. R. Co.,* 37 F. (2d) 593, 596.

Nor may a device which answers the description of the section be used to defeat the remedial purpose of the Act because of the manner of its creation or the otherwise useful function it was intended to perform. Options are granted in numberless ways. For example, it may be attached to a particular class of stock, or separately granted to stockholders upon an increase of capital; it may be voted to a favored few, or given for services rendered. However obtained, the option can be used by the insider to acquire the listed security for a short-swing profit. The Act was designed to prevent the improper, not the ligitimate, use of the device. It is therefore no answer to say that convertible stock serves a legitimate purpose. So do the other forms of options alluded to. None has been forbidden or impaired as a lawful instrument of corporate practice.

Considered in the light of its purpose § 3(a)(13) must include any option device which can be used to evade the liability imposed by § 16(b). If an acquisition of stock, accomplished by exercise of the conversion option, were not deemed a purchase within the broad definition of § 3(a)(13), the Act would be rendered impotent.

However, as the parties are in accord as to the meaning and purpose of the sections of the Act under consideration, the question decided by the Circuit Court was not an important question of statutory construction meriting review by this Court. The case presented the narrow issue of the application of the Act to a particular transaction—a transaction that is indistinguishable from many others of the same category. It differs from the others, if at all, only in detail, not in kind.

POINT II.

The petitioners' acquisition of common stock upon conversion of the preferred constituted a purchase of such common stock within the meaning and intent of § 16(b).

A. "Purchase", as used in the Act, includes any voluntary acquisition of a listed security.

Petitioners contend that the conversion of preferred stock into common is not a "purchase" within the *language* of § 16(b). The supporting argument derives from an interpretation of the word "purchase" in its colloquial rather than statutory sense. Though "purchase" itself was not defined by the Act, § 3(a)(13), by enlarging its scope, discloses a clear intent that the word be given a broad, unrestricted meaning. Its full import must be sought from associated words and the declared purpose of the Act.[6]

"Purchase" ordinarily represents an executed transaction. In declaring that the word includes a contract to buy, purchase, or otherwise acquire, § 3(a)(13) has added the executory transaction as well. But in describing the kind of executory transactions that are included by "purchase", § 3(a)(13) is equally describing the kind of executed transactions which are embraced by the word. If Congress had intended, in the case of a present transaction, to restrict the application of the Act to a cash purchase, § 3(a)(13) would have added only its corresponding executory contract. Having added also the executory "contract to otherwise acquire", it is plain that in its executed phase

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[6] *Smolowe* v. *Delendo Corporation*, 2 Cir., 136 F. (2d) 231, 238, cert. den. 320 U. S. 751; *Helvering* v. *Hammel*, 311 U. S. 504, 510; *Burstein* v. *U. S. Lines Co.*, 2 Cir., 134 F. (2d) 89, 93.

"purchase" was meant to represent any form of acquisition. To adopt the petitioners' restricted construction of "purchase" one must assume that § 3(a)(13) arbitrarily included the executory contract to otherwise acquire, that is to say, a transaction entirely extraneous to the definition of "purchase". The assumption is not warranted.

"Purchase" is defined as the acquisition of property "by one's own act or agreement, as distinguished from the act or mere operation of law".[7] When used in a statute or regulation the word is given this broad definition.[8] Hence even as "purchase" includes any executory contract to otherwise acquire (*vide* § 3(a)(13)), so it normally represents any present acquisition, whether for cash or otherwise, and concededly the petitioners, as a result of their conversion, "otherwise acquired" the common stock.

Additional support for this view may be found in § 16(b) itself. The section excludes from its operation any security which "was acquired in good faith in connection with a debt previously contracted". It is clear, first of all, that "purchase" was used interchangeably with "acquisition". Second, by expressly excluding a security acquired otherwise than for cash, the section indicates that "purchase" was used in the broadly defined sense of any acquisition; conversely, if the word carried the sole meaning of a cash transaction it would not be necessary to exclude, in express terms, a different type of transaction. Finally, in specifying the particular acquisition which shall be exempted, § 16(b) by implication includes all other acquisitions.

Petitioners say that "purchase" involves the acquisition of a new interest while conversion involves only a change of an existing interest into another form. This

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[7] Funk & Wagnalls' New Standard Dictionary, 1940.
[8] *Johnston* v. *United States*, 9 Cir., 145 F. (2d) 137, 138.

distinction is more apparent than real and stems from the use of words without regard to their legal content. In electing to convert the petitioners exercised an option to acquire a new interest, common stock, and thereby changed their status with relation to the company from preferred stockholder to common stockholder. Though in a loose sense their conversion involved the change of an existing interest, it nevertheless involved the acquisition of the new common stock The point is that § 16(b) is not concerned with the means employed in accomplishing the acquisition (by the surrender of preferred stock rather than the payment of cash) but only with the acquisition itself.

The petitioners contend (p. 9) that if the Circuit Court's decision is sound it must follow that stock acquired by inheritance or gift is also within the compass of § 16(b), a result at variance with the statute's intent. The argument is predicated on a miscontruction of the opinion. We agree and it is implicit in the opinion that the acquisition must be a voluntary one; that § 16(b) may be invoked only when the fiduciary himself takes a position in the company's security. Here, the petitioners voluntarily elected to convert to get the advantage of the higher value enjoyed by the common stock.

Finally, petitioners assert that though § 3(a)(13) defines "purchase" as including any contract to otherwise acquire, in their case the contract to acquire the common stock was made in 1937 when the convertible preferred was purchased, whereas in January, 1944, when the conversion was effected, they entered into no contract to otherwise acquire. The inference is that since a greater period than six months separates the contract to otherwise acquire from the sale, the profit realized did not inure to the company. The argument is based on the erroneous assumption that once an

executory contract to purchase is made, the actual purchase thereafter occurring must be ignored in determining the six months' period embracing the purchase and sale. In effect their position is that in such event the date of the contract rather than the date of the purchase itself controls. Nothing in the statute supports this view. When a purchase is followed by a sale liability results regardless of the fact that the purchase had been preceded by a contract to purchase. The statute permits the corporation to select either act (the contract to purchase or the actual purchase) as the initial transaction in computing the six months' period. It would not be in consonance with the declared purpose of the Act to leave the choice with the fiduciary since it would be a simple matter to arrange a preliminary contract, even in the case of a cash purchase, and wait for a favorable time to consummate it.

B. The declared purpose of the Act requires that "purchase" be liberally construed so as to include any voluntary acquisition of a listed security.

We dare say the word "purchase" was deliberately left undefined in the statute for if specific transactions had been described as coming within its purview, the way would be left open for many ingenious forms of evasion. On the other hand, the word's accepted meaning in legal usage (as any acquisition) is broad enough to make the application of the statute to a particular transaction comparatively simple once the transaction is examined in the light of the declared purpose of the Act.

As the statute was enacted to curb a widespread evil, it is a distinction without a difference that a short-swing profit is made by means of an acquisition of stock through con-

version rather than for cash. Since Congress thought it necessary, in order to close an obvious avenue of evasion, to treat a contract to otherwise acquire as a purchase within the Act, it is not logical to say that a present acquisition was meant to be excluded. It needs little emphasis that a present acquisition is the more frequent, more usual transaction resorted to. Allowing the fiduciary to keep the profit in the one case and not in the other will surely destroy the effectiveness of the Act.

If an acquisition through conversion is entitled to exemption from the statute, then by the same token any stock that has been borrowed or acquired through an exchange for other stock should enjoy a like exemption. The petitioners, to be sure, do not make this contention as it finds no support in logic or reason. Yet in principle, one such acquisition should be as free from the condemnation envisaged by the Act as either of the others. It is plain therefore that if in the process of construction exceptions are allowed to creep into § 16(b) the attrition of the Act will have begun. Only the broadest definition of "purchase" can prevent its emasculation. By giving it the meaning of any acquisition, a meaning that is neither strained nor uncommon, the Circuit Court construed the word in harmony with the Act's intended purpose.

POINT III.

The petitioners' acquisition of the common stock was not exempted from the operation of § 16(b) as an acquisition "in good faith in connection with a debt previously contracted".

Petitioners maintain (pp. 13-15) that their acquisition of the common on conversion falls within the exemption contained in § 16(b). The argument is that their contract right

to convert imposed an obligation on the company to respond to a request for conversion and that such obligation was equivalent to a debt previously contracted. The argument was rejected in the Court below as a distortion of the phrase "a debt previously contracted". Read in its context the word "debt" has only the commonly accepted meaning of an indebtedness payable in money or kind.

That it was not used in the loose sense advocated by the petitioners can be seen from their own argument with respect to § 3(a)(13). The petitioners, it will be recalled, concede that § 3(a)(13) was designed to bring options within the scope of § 16(b). An option, precisely like a convertible right, imposes an obligation on the company to deliver stock upon request of the option holder. If a "debt previously contracted" represents the sort of obligation suggested by the petitioners, then by the same logic all options are exempted under the exception contained in § 16(b). It is obvious that the petitioners' construction of the word "debt" is entirely untenable.

Petitioners overlook an integral part of the exemption clause, namely, that the security was acquired "in good faith" in connection with the debt previously contracted. This phrase makes it unmistakably clear that when speaking of "debt" the statute is referring to an ordinary indebtedness. To constitute a "good faith" acquisition the creditor must show that he was faced with the alternative of not being able to collect the debt in cash. In short, the exemption deals with an involuntary acquisition, one that completely negates the presumption that the insider was taking a market position in his company's securities in order to capitalize on inside information.

The cases cited by the petitioners do not support their view. The obligation to convert is a duty rather than a

debt. It has been expressly held that "The liability of a corporation to its stockholders on account of their stock is not a debt".[9]

POINT IV.

§ 16(b), as applied to the defendants' acquisition of common stock upon conversion, is constitutional.

In challenging the constitutionality of the Act the petitioners advance the theory that as Congress sought only to curb short-swing speculations by insiders but did not intend to curtail the use of convertible securities, any attempted restriction upon the use of convertible stock has no real or substantial relation to the objects of the Act. The short answer to the argument is that the petitioners have misleadingly equated the evil of short-swing speculation by insiders with the means used to accomplish it.

§ 16(b) was not designed to eliminate the legitimate use of traditional corporate practices. Though § 3(a)(13) prevents the use of an option as a device to evade liability, it has not abolished or otherwise restricted it; nor has Congress denounced it as an evil in itself. So with the convertible security; it has a proper function to perform and when not used in contravention of § 16(b) is not subject to any restrictions. On the other hand, when used as a device to evade the Act, it is, like any other option, subject to the application of § 16(b).[10]

But the right to convert is not in the least affected by the statute—no more than is the right to purchase a security for cash. The Act is applied only when an acquisition is followed by a sale within six months.

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[9] *Eyster* v. *Centennial Board of Finance*, 94 U. S. 500, 502.
[10] *East New York Savings Bank* v. *Hahn*, 326 U. S. 230, 232.

Conclusion.

The petition for a writ of certiorari should be denied.

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Dated, July, 1947.